

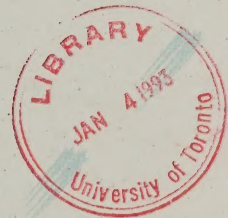
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Report Prepared for the Research Division
Royal Commission on National Passenger Transportation

Airline Subsidies: Three Case Studies

Richard J. Schultz
November 1991

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Opinions expressed are those of the
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the Royal Commission on National
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AIRLINE SUBSIDIES: THREE CASE STUDIES

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AIRLINE SUBSIDIES: THREE CASE STUDIES

One of the dominant trends in public policy in Canada over the past decade has been a much more explicit and coherent effort to assess the appropriateness of specific policy instruments for the attainment of public objectives. This has not always been the case. In many instances, little attention was paid to matching instruments and goals; appropriateness was assumed or certainly not questioned. In others, the panoply of governing instruments - taxes, subsidies, public ownership and regulation - was employed based on the questionable assumption that with such a complete arsenal at work policy objectives could not but be met.

The fiscal exigencies of the past decade combined with a more philosophical concern over the merits and legitimacy of specific objectives and forms of government intervention in the economy have resulted in a rejection of the "shotgun" approach to policy implementation. Today there is much more concern for finding the appropriate match of public objective and instrument.

The transportation sector in both Canada and the United States exemplifies both the traditional and the current approaches. In Canada, to meet public policy goals in the air sector, governments over the past fifty years have employed a mix of public and private ownership, direct economic regulation of entry/exit and prices as well as direct and indirect subsidies. The American approach was identical save for the absence of public ownership.

Starting in the United States with air deregulation in 1978 and followed by comparable reforms in Canada in 1987, we have witnessed both a shift to a more focussed, limited role for government intervention and a concentrated search for the appropriate matching of continuing public objectives and policy instruments.

One of the common concerns of both periods of air transportation policy-making was meeting the passenger service needs of small and/or remote communities. The subject of this report is one particular aspect, namely, the use of public subsidies to satisfy those needs. In the United States, in both the pre- and post-deregulatory periods, direct subsidies have been employed albeit in different formats. In Canada as well, subsidies have been employed prior to the substantial deregulation of the air sector in 1987. In the Canadian case, subsidies were employed by the federal as well as at least one provincial government, Ontario. In the latter case the subsidization of passenger service continued after the federal reforms, albeit in a different form.

The purpose of this report is to analyze the record of the employment of public subsidies as a means of addressing the air transport needs of small and/or remote communities. In particular, this report examines:

1. the factors underlying the choice of subsidies as a policy instrument;
2. the nature of government objectives and how these were translated into criteria for deciding which communities would receive specified levels of service;
3. the circumstances under which carrier subsidization was successful or unsuccessful; and
4. the particular administrative arrangements that contributed to success or failure.

The report consists of three case studies of the employment of subsidies for passenger air service. The first is a study of the Essential Air Services program established as part of the United States air deregulation of 1978. The second study is of the subsidy program established by the Canadian federal government in the 1960s as part of the fundamental

reworking of national air policy undertaken at that time. The final case study examines the Ontario Government's program to subsidize air service in Northern Ontario. This was begun in 1971 and continues today, although in a very different form from the original.

1. Case Study One: The U.S. Essential Air Services Program

A cornerstone of the 1978 Air Deregulation Act in the United States was the provision allowing carriers to terminate service to a community without regulatory approval. At the time that this legislation was proceeding through Congress, one of the major objections to it was the fear that some communities could lose all air service. This fear led to the creation of the Essential Air Service Program to guarantee service to designated points. For our purposes, there are two essential points to be made about this program. One is that it was not the first air service subsidy program in the United States. Local air service for some communities had been subsidized since 1945. The specific features of the 1978 program were in large measure an attempt to remedy widely recognized defects in the existing program. Consequently the nature of the original program needs to be discussed in order to understand the 1978 program. The second point is that the 1978 legislation included a "sunset" provision for the Essential Air Services Program. It was to last only ten years and to end in 1988. In 1988, however, as a result of political objections the program was both extended for an additional ten years and modified. The rationale for extension and the modifications need to be understood in order to offer a full assessment of the program.

1.1. The Original Local Air Service Subsidy Program

The American air regulatory system created in 1938 was built on two pillars. One was that competition would be rigidly controlled through the licensing of entry on grounds of "public convenience and necessity." The second was the use of subsidies for carrying mail - subsidies that were paid only to licensed carriers. The number of those carriers would be limited to those in operation as of 1938, which were consequently "grandfathered" and given the only licences for trunk lines in the United States in the period 1938-1978.

These carriers served the major city routes, however, with the result that many small communities began to demand licensed air service. This pressure which developed during the Second World War became so great that the Civil Aeronautics Board (CAB) initiated an investigation into the feasibility of licensing feeder air service. (Eads, 1972, pp. 75-104) Although the CAB was not confident that there was the necessary market demand for such service, the political pressure was apparently sufficient to persuade it in 1945 to undertake a "local service experiment." Carriers licensed under this experiment were to be given only temporary certificates for a three year period and were to be prohibited from competing with established trunkline carriers.

From the beginning it was recognized that the local air service providers would require a subsidy. (Eads, 1972, p.88) The program that resulted was flawed in three basic respects. The first was the apparently open-ended, unlimited nature of the amount of subsidy available both to individual carriers and to local service feeders generally. The CAB had initially rejected a cap on the amount of subsidy available and opted as a control mechanism the use of "temporary" licences. Its reasoning was that these would "serve as a safeguard against a static or progressively increasing dependence on the Government; and will permit the subsequent giving of permanent status only to such services as will have shown during the life of a temporary certificate that they are capable of operating without undue cost to the Government and of a progressive reduction of such costs." (Quoted in Eads, 1972, p. 89)

Unfortunately, by rejecting a cap on the amount of subsidy available, despite its best intentions the CAB in effect created an almost open-ended cost-plus subsidy system. The primary reason for this development was that by the time the CAB had to address the nature of its "experiment" after three years, the feeder airlines had developed sufficient political support that the Board was forced to abandon its original plan and within ten years Congress gave permanent certificates to the overwhelming majority of the local service airlines.

The second major flaw in the program was that there were minimal controls imposed on the costs for which the airlines were reimbursed. One cost in particular was crucial: the cost of aircraft. Although the intention of the designers of the program was that licensees would use relatively small, cost-efficient aircraft, licensees inevitably opted for larger, much more expensive aircraft for which they could not attract a reasonable load factor to cover their costs. Airlines that opted for larger aircraft than required by their markets were not punished by the CAB. Consequently they required and were granted an even larger subsidy. Unlike the situation that was supposed to develop in Canada when federal subsidies were introduced, the CAB was not given responsibility or even a role as part of the fare regulation system to consider the appropriateness of carrier aircraft purchases.

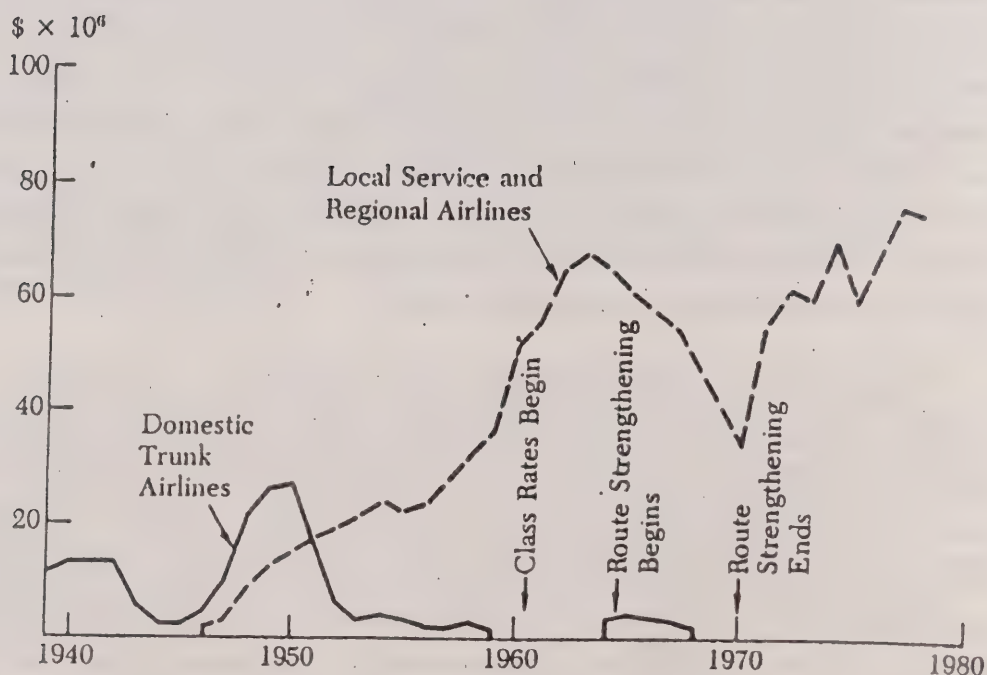
The third flaw was that there were no service or quality controls on the airlines receiving subsidies. Although the subsidy formula changed over time, generally a class rate formula was employed to determine the amount of subsidy each carrier received. According to Meyer *et al.* (1981 p. 140) the subsidy was based on "... (1) the number of days each eligible point was served, (2) the number of departures from each eligible point, and (3) the number of plane miles flown in subsidy-eligible service." The important point to note here is that while in principle the subsidy was point-specific, in effect it was carrier-specific. This encouraged what became to be perceived almost unlimited, uncontrolled growth in the subsidies being paid to eligible carriers.

Rather than reassessing the eligibility criteria or attempting to put a cap on the overall subsidy program, the CAB sought alternative methods for reducing the need for subsidies. The most important initiative by the Board was to allow the local carriers to compete in particular markets with the trunk carriers. The rationale was that if they were successful and earned a profit on such routes they could cross-subsidize some of their unprofitable routes. The result, however, was again contrary to the Board's objectives. As Kaplan notes (1986, p. 66) "carriers faced incentives to provide frequent flights at not particularly convenient times.... By scheduling service to small communities at off-peak times, the carrier's equipment was available for more lucrative markets during peak

periods." It is important to note that while the CAB prior to deregulation had authority over air fares, there is no evidence to suggest that specific subsidy-related concerns were a factor in their approval process.

The overall effect of the original program was to create an increasingly expensive program that was not meeting its objectives and for which there were inadequate public controls. Figure 1 shows the growth in the subsidies for the period 1938-1978. Although successive administrations sought ways to cut back the program these were almost all unsuccessful. By 1980 they had grown to U.S.\$80 million and to \$95 million only one year later. (Vellenga and Vellenga, 1986, p.340)

FIGURE 1
Subsidies Received by U.S. Certified Carriers, 1938-1988



Source: Meyer, et al., 1981, p.28

1.2 The Essential Air Services Program 1978-1988

As previously indicated, the creation of a subsidy program to guarantee service to small and remote communities was a sine qua non for the acceptance of air deregulation in 1978. Advocates of such deregulation, including those in the Carter Administration, were equally adamant that any subsidy program correct the fundamental flaws demonstrated by the existing local service subsidy program. The result was the Essential Air Service Program (hereafter EAS Program) established under Section 419 of the Federal Aviation Act in 1978 to replace after a transitional period the original subsidies provided under Section 406 of that legislation.

Congress determined the initial threshold for eligibility for the program by stipulating in the legislation that all communities receiving air service from a licensed carrier could continue to receive "essential air service" for a ten-year period with a federal subsidy if this was necessary. (U.S. Department of Transportation, 1987, p. 7.) This guarantee was to meet the fears of loss of service on the part of opponents of air deregulation. More specifically Congress instructed the CAB to issue "essential air service determinations" for all communities served by one or more certificated carrier as of October 24, 1978. In addition Congress stipulated that all communities deleted from a Carrier's licence in the ten years prior to October 1978, as well as any community in Alaska or Hawaii designated by the CAB, could be granted an EAS designation to be eligible for a subsidy. The significance of the EAS determinations was that they "established the level of service below which an incumbent carrier could not reduce operations without giving prior notice to the Board and the community." If a carrier filed notice of its intention to reduce service below that level then the Board and subsequently the Department of Transportation (following the abolition of the Board in 1984) could order the carrier to continue service until a replacement could be found. The legislation, as indicated, provided for payment of a subsidy for either the incumbent or the replacement if this was necessary.

The legislation also stipulated the level of service that was the minimum acceptable. Such service was to consist of at least two round trips five days per week or the level of service provided in 1977, whichever was less, for those communities outside Alaska, and two round trips per week or the level of service provided in 1976, whichever was greater, for those communities in Alaska. A crucial aspect of the legislation is that it did not require that service be provided by jet aircraft even if that was the type of service the community had been receiving. Moreover, for the first time commuter aircraft were made eligible for the subsidy.

All subsidiary requirements concerning nature of aircraft, capacity, stops, timing and any other quality of service issues were delegated to the Board to establish. The Board which had proposed in 1972 to replace the existing subsidy system with a low-bid contracting system (Kaplan, 1986, p. 67) proceeded, after consultation, to establish conditions which would meet the aims of providing essential service subject to much more stringent conditions than the original subsidy plan.

The first criterion was the designation and number of "hubs" to which round-trip service would exist. A "hub" was defined as any point emplaning more than 0.5% of the total revenue passenger-miles in all services in the United States. (Lin, 1985, p. 16) The Board's ruling was that essential air service would consist of at least two round trips on weekdays and weekend periods between the EAS point and at least one hub and exceptionally to two hubs but no more. (U.S. Department of Transportation, 1987, p.8) Such service would give passengers access to the entire U.S. airline network. Service to two hubs was conditional on there being "a sufficient overall level of traffic and sufficient numbers of passengers in two directions".(ibid, p.9)

One of the problems with the original subsidy plan was that it did not encourage airlines to use the most cost-efficient aircraft and consequently larger jet aircraft were often employed. To correct the resulting problems of "... extremely low load factors, uneconomic and wasteful operations by the carriers, and substantially higher subsidy costs for the government..." (*ibid.*) the CAB in the EAS Program imposed a ceiling on the capacity it would guarantee based on the level of demand. This capacity was a maximum of 40 daily emplanements per day. If there was greater demand, the assumption was that the service would be self-sufficient and therefore not eligible for a subsidy.

The three final criteria concerned the size of aircraft, number of stops and time of flights. With respect to the first, while the Board did not stipulate an aircraft size, it did require minimally that the aircraft have two engines, require two pilots and have access through stairs rather than over the wings. EAS communities could, however, waive these requirements if they so wanted. On the matter of flight times, the Board insisted that flights depart at reasonable times depending on the purpose of the travel. Finally a maximum of two stops between the EAS point and the hub was permitted unless the community was agreeable to additional stops. The result of this was that "service under 150 miles would be non-stop, between 150 and 250 miles could have one-stop and service over 250 miles could have two stops...." (*ibid.*, p.8)

As noted earlier, although licensed carriers under deregulation could abandon service, this was subject, in the case of EAS points, to continuing regulatory oversight. If the CAB or DOT could not find a replacement, the existing carrier could be required to continue to offer service subject to the above criteria and in return receive a subsidy to cover the necessary costs until a replacement could be found. In general, the determination of the recipient of individual EAS subsidies was based on a contract bidding system. This was not a low-bid system only, as the legislation required the Board to consider the applicant's service quality as well as the preferences of the EAS community. Once selected, the carrier was required to maintain service for a set subsidy for a minimum of two years. If the route was more profitable than predicted, the subsidy was not reduced; on the other hand, if demand was less than expected, resulting in lower profits, the subsidy would not be increased during the period of the contract.

Overall the Essential Air Services Program has been judged a success in meeting its two main objectives of providing continued air service at adequate levels and at reduced cost. In 1987, when a congressionally mandated review was undertaken, it was reported that of the 321 designated communities in the 49 states (excluding Alaska), 219 were receiving unsubsidized service and based on the program's criteria could be expected to do so if the program was ended. At the same time, 102 of the original EAS communities and four newly-designated points were being subsidized. (U.S. Department of Transportation, 1987, p.1) In Alaska 41 communities were receiving subsidies.

The comparisons with the pre-1978 subsidy program and the EAS program for the mainland 48 states are significant, both in terms of the cost of individual point subsidies and the overall program cost. Individual subsidies have declined dramatically. In 1978 when 202 communities were subsidized, the cost was approximately U.S.\$355,000 per community, with an overall cost of \$71.7 million. (U.S. Department of Transport, 1987, p. 13) In 1987, the overall cost had been reduced to approximately U.S.\$21 million and an average cost of \$216,000 per community. The cost of the Alaska subsidies was an additional \$6 million. Table 1 provides information on the 1978-86 period for the 48 mainland states.

TABLE 1
U.S. Air Services Subsidies 1978-1986
(48 Mainland States)

Fiscal Year	Section 406 Subsidy		Section 419				Total Subsidy
			Hold-In		Normal		
	Points	Amount (000)	Points	Amount (000)	Points	Amount (000)	(000)
1978	202	\$71,667	-	-	-	-	\$71,667
1980	153	\$72,874	23	\$8,423	39	\$1,449	\$82,746
1982	45	\$44,617	40	\$8,262	88	\$16,966	\$69,845
1986	-	-	8	\$1,186	98	\$20,520	\$21,706

Source: U.S. Department of Transportation, 1987, p. 13

1.3 The Essential Air Services Program 1988-

The Air Deregulation Act of 1978 included a sunset provision for the EAS Program. It was to be terminated ten years after the Act had been enacted, i.e. October 1988. The Report cited in the preceding section was mandated by Congress to determine what the effects of termination would be on small and remote communities and to assess whether there was a need or justification for any continued subsidies after 1988. (*ibid.*, p.3) In its report the Department projected that, if subsidies were terminated in the 102 communities in the 49 states (excluding Alaska), 24 would continue to receive some level of service, 70 would probably lose all service and the impact on 8 was uncertain. (*ibid.* p.15) In the case of Alaska, the projection was that almost all of the 41 communities then receiving a subsidy would continue to be served although at reduced levels and in some cases by air taxi service. The Report also noted that of the 70 communities that would lose service completely, 33 were 75 miles or less from other communities with air service; 29 were between 76 and 150 miles of other cities with service and 8 were more than 150 miles from alternative air service (p.16).

Although the Report did not offer any recommendations, the position of the Department appears to have been opposed to the continuation of the EAS Program on the grounds that the program was unnecessary. (Craun, 1991; the information that follows is from this source.) Congress, however, thought differently and in 1987 decided to extend the Program for an additional ten years. A further review will be taken by 1998 before the Program is extended or terminated.

In addition to extending the Program, in response to lobbying from recipient communities about the quality of the service provided, Congress modified some of the Department's specifications for the Program. One change was that the minimum size of aircraft was set at 15 passengers rather than the previous eight passenger limit. In part this was to respond to the preference of passengers for pressurized aircraft. A second change was to impose a maximum of one stop from the EAS point to its hub. Finally Congress voted to let new points not covered by the original 1978 criteria be eligible but subject to a significant condition favoured by the Department. That condition was that the

subsidy for new EAS points was to be jointly funded by the federal government and that of the local community on a 50-50 basis. It is noteworthy that, as of April 1991, no new points had been added.

Although Congress renewed the Program for ten years in 1987, no additional funding was provided at that time. The freeze on the Program combined with additional requests for eligibility under the original criteria led to 26 EAS points losing their designation because the funding was inadequate in 1988. More recently, however, the funding has been increased by U.S.\$12 million to cover all currently eligible communities for the period 1992 to 1998.

2. The Canadian Federal Air Subsidy Program, 1966-75

The Canadian air subsidy program was much more limited - in objectives, in duration and in total subsidy - than the American program. The subsidy program was initiated in 1966 as part of a fundamental reformulation of national air policy and was terminated in the 1970s. From the outset the federal government emphasized that objective was a "limited policy of temporary subsidies."

To understand fully the factors underlying the introduction of air subsidies in Canada, it is important to appreciate the larger air transport policy context of the time. (See Schultz and Alexandroff, 1985, pp. 41-47) National air policy as determined by the federal government had been to grant Air Canada (from 1938 to 1965 known as TCA or TransCanada Airlines) a monopoly on national trunk routes and on all "routes being designated as being of national importance." This monopoly was breached partially in 1961 and more significantly in 1966-67 when Canadian Pacific Airlines was permitted to compete with Air Canada on the national routes but "... there must not be the kind of competition which would put TCA into the red...". (quoted in *ibid.*, p. 43) The overriding objective of protecting Air Canada from undue competition was to keep it strong enough

on the lucrative routes so that the airline itself could engage in the necessary cross-subsidization of less profitable or unprofitable routes. Through the instrument of cross-subsidization the Government of Canada would not be called upon to use public monies to subsidize passenger service.

The issue of direct subsidies arose, however, at the time of the reformulation of national air policy because of the existence of five regional scheduled air carriers. The federal government was concerned not only with limiting direct competition to Air Canada from Canadian Pacific but also from the regional carriers to both national airlines. Consequently, as part of the restatement of air policy, the government opted to limit substantially any competition between the regionals and the national trunk carriers by consigning the five regionals to specific territories. The regionals would not be permitted to "be directly competitive on any substantial scale...." To further the policy objectives, the federal air regulator was given authority to screen regional carrier aircraft purchases as part of its licensing process. The goal here was to constrain the regionals from acquiring larger aircraft, particularly jets, that required larger passenger loads to be cost-effective and therefore would need access to the more profitable routes, i.e. those assigned to the national carriers. Notwithstanding this statement of intention, the CTC did not assume such responsibility. (Janisch, 1978, p.33)

The explicit objectives underlying the "limited policy of temporary subsidies" were enunciated at the time the federal government announced its restrictions on the regional carriers. Subsidies, henceforth for an unspecified period of time, could be granted under the following circumstances (Minister of Transport, 1966):

1. Where air service is needed to a remote area which requires the maintenance of regular air service for its existence; and where other means of transport are inadequate or non-existent.
2. Where a developmental activity is involved and air service is essential to the support of that activity.

3. Where a regular route operation appears to have a good chance of success but requires support during the initial period of growth.
4. Where an established route needs to be withdrawn but gradual withdrawal is needed rather than immediate cessation.
5. Where by payment of subsidies, higher costs to the federal government, for example in the development of facilities or alternate transport, may be avoided.

The government also indicated that it would impose a "use it or lose it formula" involving minimum traffic volumes to justify any subsidies. It is important to note, however, that the government does not appear, at least in terms of available public information, to have defined or otherwise operationalized these criteria. In this respect the CTC generally, and not only in the air sector, was reluctant to articulate publicly its underlying policies. (Janisch, 1978, pp. 109-114)

Notwithstanding the explicit objectives advanced by the government for the introduction of the subsidy program, the primary factor underlying the program was unstated. The government sought to "buy off" the regionals for the constraints that were being placed on them. In particular, by denying the regionals access to the more profitable trunk routes the government could not opt for the alternative that the American regulators had previously tried, namely, reducing the subsidy cost by strengthening the local carriers. If this alternative had been attempted, the fear was that Air Canada's revenues would be threatened and the national public airline would request direct subsidies for its non-profitable routes. Consequently, under the guise of a subsidy program for routes, the government was actually seeking to compensate regional airlines.

The government's reluctance to engage in subsidizing passenger service is shown by the very limited amounts of subsidies paid during the program's existence. The first payments were made in 1967 and only amounted to little over \$1.5 million. By 1974 the amount had grown by only another \$0.5 million. The comparison with the growth in the American subsidy totals provided above in Figure 1 is striking. Over the eight years from 1967 to 1974, the total amount of the subsidies made available was approximately \$14.7 million or less than \$2 million a year on average. Table 2.1 shows the annual amounts for this period.

TABLE 2.1
Regional Air Subsidies, 1967-1974

1967	\$1,556,461
1968	\$1,613,642
1969	\$2,040,404
1970	\$1,855,000
1971	\$1,604,539
1972	\$1,933,788
1973	\$2,066,066
1974	\$2,021,000

Source: E.E. Johnston et. al, 1976, p. 100.

Although the subsidy totals reinforce the "limited" extent of the government's commitment to a subsidy system, the time limits of the "temporary" policy were never articulated. It is quite possible that had not other factors intruded the Canadian policy could have gone the way of the earlier American "experiment" to become a permanent fixture of Canadian policy. Certainly the regional air policy began to face serious stresses within a few years of its introduction. One of the more important was that the government itself was compelled by political pressure to overturn its regulator to grant one of the regionals, Eastern Provincial Airlines (EPA), direct access to Toronto from Halifax in direct opposition to its own policy.

In any event, the subsidy program was wound down as the individual regional airlines disappeared in the 1970s and early 1980s. Starting first with the Pacific Western Airlines (PWA) purchase of Transair and followed by Air Canada's purchase of Nordair, CPA's acquisition of EPA and the bankruptcy of Quebecair, the regionals disappeared. As they were the only carriers eligible to receive the subsidies, the subsidies were also terminated thus satisfying the government's "temporary" objective.

3. Ontario and the norOntair Subsidy Program

The longest continuing air passenger subsidy service in Canada is that provided under the Government of Ontario's norOntair program. This program was established in 1971 and is still operating, although under a different format since 1988. The following analysis will distinguish between the two periods.

3.1 norOntair 1971-87

The origins of the Ontario subsidy program can be traced to a request in 1969 from a small northern Ontario local air carrier for a subsidy to enable it to continue to provide scheduled service between two northeastern points. (CTC, 1983, pp. 3-7; much of the information on the period 1971-83 is drawn from this source.) The Government of Ontario was not prepared to provide a subsidy for a particular airline and consequently rejected the request. It was concerned, however, about the inadequacy of existing air service provided primarily by Air Canada that linked Northern Ontario points to major centres such as Toronto as well as the almost total absence of intra-regional scheduled service. In the latter case, the situation was so bad that "if a traveller wished to go from Sault Ste Marie to Sudbury (a trip of 284 km), it was necessary to travel first to Toronto (493 km) and then from Toronto to Sudbury (340 km) a total of 833 km." (*ibid.*, pp. 8-9)

It is important to note that the subsequent proposal to create a subsidy system was not Ontario's initial foray into encouraging air service in the North. For several years it had subsidized the construction of airports in Northern Ontario provided that local communities contributed 20% of the cost. In addition it subsidized the cost of the operation of the airstrips and specialized equipment such as radio beacons.

The combination of the inadequacy of air service, the existing airport subsidy programs and the subsidy request led Ontario to create the norOntair air passenger subsidy program. After reviewing the existing situation, the government concluded that there was a need for local service but that it was insufficient to be attractive to private carriers. (Bernier, 1971, cited in CTC, 1983, p. 15)

The objectives of the program were set out in an Ontario Government submission to the Canadian Transport Commission in 1971. They were generally to enhance the opportunity for industrial and commercial development; to reduce social isolation; and to strengthen the private air carriers. (CTC, 1983, p. 17) As the government subsequently stated (cited in Schultz and Alexandroff, 1985, p. 48):

"The norOntair service was initiated by the Government of Ontario as a component of the regional development mandate of the Provincial Government. It was considered that in northern areas the future air transportation systems are especially important to the development plans. Because of great distances and low population densities it was considered that air transport will have a great impact on the economic and social opportunities of the northern part of Ontario."

More specifically, Ontario cited the inadequacy of existing air service as well as inadequate or non-existent passenger rail service to communities for which there was an identified community of interest.

Notwithstanding the interest that would be shown by provincial governments such as Alberta and Quebec in the next few years in acquiring an ownership position in a regional airline, Ontario rejected such an option as it had that of subsidizing a specific existing operating company. It opted instead to offer by way of competitive tender a contract with an airline to provide what it described as "a basic level of scheduled air service" (Ontario Northland Transportation Commission, 1990) to specific communities. Under the terms of the contract, Ontario would provide aircraft on a leased basis and would construct the schedule of service. The contract would also specify the fixed and variable costs that would be covered and initially also included a bonus as an incentive for reliability and completion of service terms. Subsequently, the last item was deleted because of concerns over excessive pressure on crews to perform in a manner that might be detrimental to safety considerations. The successful contractor was also required to work effectively with any existing trunk carriers to ensure air service was integrated. Finally, the contractor was required to obtain approval from the Canadian Transport Commission to operate the service under the name of norOntair. The Government intervened in support of such applications and sought to ensure that the Federal Ministry of Transport would endorse any applications. Fares charged by norOntair, until deregulation in 1987 were subject to the CTC's regulatory controls.

Initially norOntair was limited to providing service between four Northeastern Ontario communities: Timmins, Earleton, Sudbury and Sault Ste. Marie. Subsequently when the original three-year contract expired in 1974, Ontario expanded the program considerably. The government established the following criteria for determining which communities would be covered by the program (CTC, 1983, p. 24):

- (a) Functional type of centre - places where business and services draw people from surrounding areas.
- (b) Isolation - places which were sixty or more minutes by road from a scheduled air service.
- (c) Population - places with a 1971 population of 2,000 or greater, and

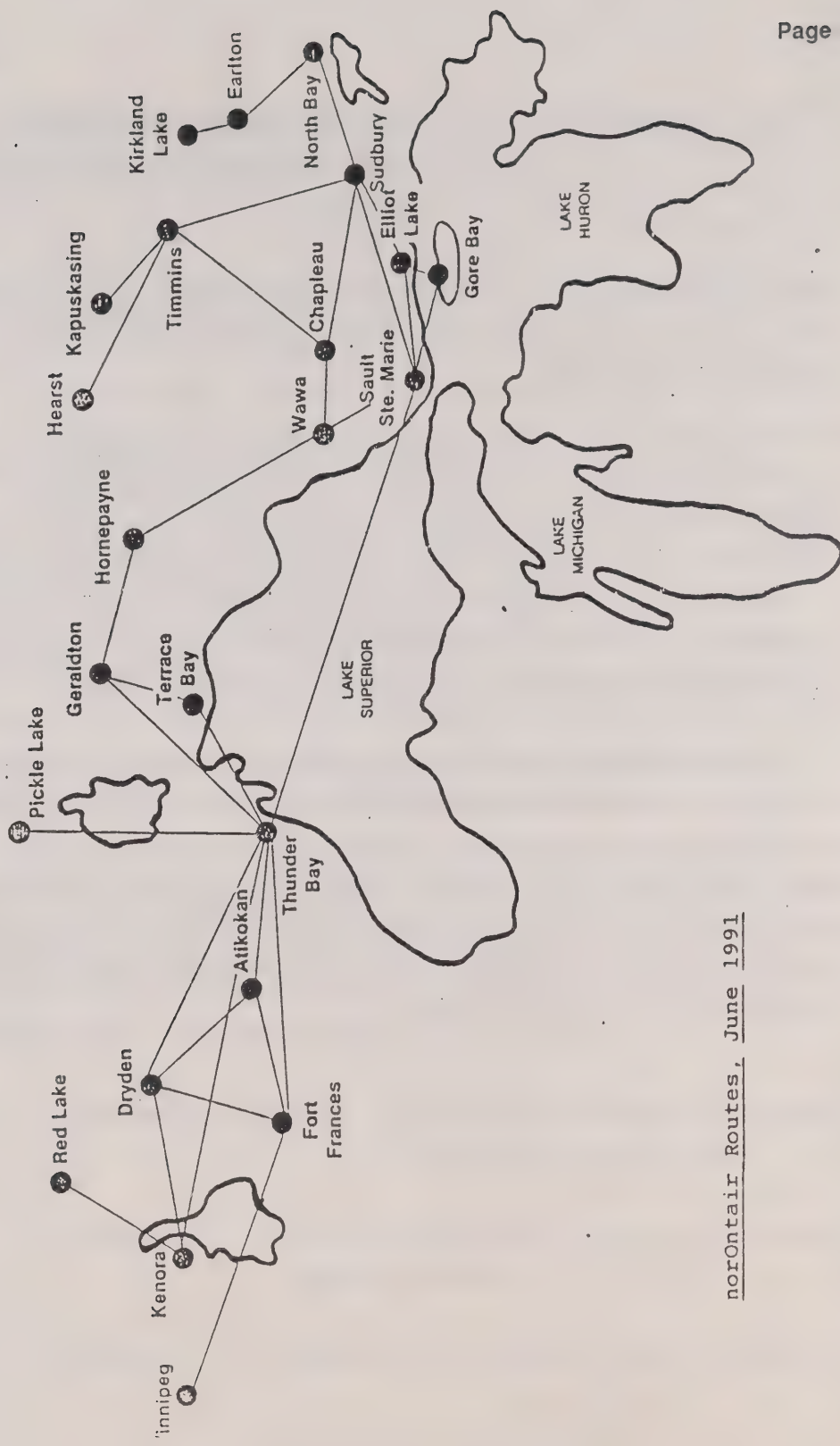
- (d) Special Cases - places which had some existing services or special market considerations which warranted examination.

These criteria produced a total of 31 centres which might be eligible and these were then matched into possible "city pairs" that were subject to further conditions such as an appropriate level of demand.

There are a number of observations to be made about the operation of the norOntair subsidy program. Since its inception in 1971 it has expanded beyond Northeastern Ontario to provide air service in all northern parts of the province. By 1975, 15 communities were being served; by 1980 the number had risen to 21 and since that time two have been added. Figure 2 shows the current routes served by norOntair. Over the past 20 years service has been dropped for only one community, although smaller aircraft have been substituted because of insufficient passenger demand.

During the period from 1975 to 1988, the contractors also expanded to four from the original one. This in part reflected the province's desire not to be too closely tied to one contractor lest it become involved in subsidizing an airline rather than service to specific communities. It is also important to note that the province has not felt compelled to automatically renew contracts with individual air operators. On occasion after a contract period expired, the next contract was awarded to a different operator whose proposed terms were more attractive to the province.

FIGURE 2



norOntair Routes, June 1991

Source: norOntair

Table 3 provides a comprehensive picture of norOntair's history from 1971 to 1990. Two specific related aspects should be noted. The first is that in the first half of the last decade norOntair felt the effects, as did other airlines, of the recession. Passenger totals dropped considerably from a high of 118,571 in 1980 to 90,641 in 1985. By 1990 they had almost recovered to the 1980 level with 114,574 passengers flying in that year. The related point pertains to the movement of the subsidy required to finance norOntair. Between the first year of operation and the tenth, the subsidy per passenger declined from \$108.23 to \$5.17. By 1985, reflecting the loss of traffic as well as the higher operating costs especially for fuel, the subsidy had risen almost tenfold to \$50.16 per passenger. The next year the subsidy per passenger reached its all-time high - except for the first year of operation - of \$58.72 per passenger. Since that time the subsidy has declined annually.

TABLE 3
norOntario Annual Summary, 1971-1990

	1971	1975	1980	1985	1990
Communities Served	4	15	21	21	23
Aircraft Fleet	2	6	8	10	9
Passengers	1,155	62,874	118,571	90,641	11,574
Operating Costs ¹ (\$000)	148	2,278	4,560	9,401	15,300
Revenue (\$000)	23	1,403	3,947	4,854	12,500
Operating Deficit (\$000)	125	875	613	4,547	2,800
Revenue/Cost (%)	16	62	87	52	82
Operating Deficit Per Passenger (\$)	108.23	13.92	5.17	50.16	24.44

Source: Canadian Transport Commission (1983), The Ontario Northland Transportation Commission.

¹ Excludes a provision for overhaul.

3.2 norOntair 1988-90

The preceding section provided data about the nature of norOntair's operations including the past two years. These years are significant for our purposes, however, because of the major restructuring that took place in 1988 in norOntair. In 1985-86, in part reflecting concern over the loss of traffic and the growth in the subsidy per passenger, the Government of Ontario proposed to sell all or some of the aircraft it had purchased to lease to the individual operators providing service under the name of norOntair. The province, however, was unable to find buyers on terms that were acceptable to it. In part, prospective purchasers had problems with the province's conditions on protecting the positions of the current employees of the contractors as well as the continued use of the aircraft in Northern Ontario. Ultimately the province was forced to abandon its plan to sell; furthermore when one of its contractors was threatened by bankruptcy it bought the firm in order to continue to provide the service.

As a result norOntair is now an operating unit of the Ontario Northland Transportation Commission (ONTC), a provincial Crown corporation that provides a combination of transportation (rail, truck, bus and marine as well as air) and telecommunications services to large parts of Northern Ontario. As a result of this restructuring, norOntair now contracts with the province, particularly the Ministry of Northern Development, to provide air service at a fixed cost. This cost is negotiated with the Ministry on a five-year basis. The airline has an incentive to be as cost efficient as it can be because if it can cut its costs so that its revenues including the subsidy exceed its costs it keeps the balance which goes into the larger operating budget of the ONTC.

According to a norOntair official interviewed for this project (Kilgour, 1991) the more direct link with the Government of Ontario has not significantly affected the operations of the carrier. Although one could have presumed that this might make the extension of service to individual communities a more politically sensitive issue, this does not appear to have been the case. Prior to 1988 if a community wished to have service it had to persuade norOntair that its traditional criteria could be satisfied so that an abnormally high subsidy was not required. After 1988 this continued although a community if rejected by norOntair could now turn to the Ministry of Northern Development for relief. The Ministry, however, cannot simply order norOntair to introduce service to a community. It must reimburse norOntair, based on the latter's estimate of the additional costs for the new service as part of its reimbursement program.

Conclusions

As noted in the introduction, the purpose of this report was to analyze by means of three case studies the record of the employment of public subsidies as a means of addressing the air transport needs of small and/or remote communities. In particular, the report has sought to address the following concerns:

1. the factors underlying the choice of subsidies as a policy instrument;
2. the nature of government objectives and how these were translated into criteria for deciding which communities would receive specified levels of service;
3. the circumstances under which carrier subsidization was successful or unsuccessful; and
4. the particular administrative arrangements that contributed to success or failure.

The objective of this concluding section is to summarize our primary findings and identify any lessons with air subsidy programs that can be drawn from the cases examined. It is important to emphasize, of course, that given the limited number of cases studied and the restricted research base upon which this report is unavoidably constructed we must treat any lessons as tentative.

To develop our summary it is appropriate, given the overlap in our four policy concerns, to collapse them into two broad areas: first, the factors and objectives behind the introduction of subsidies and, second, the factors responsible for the level of performance of the specific subsidy program.

Turning to the first set of issues, the choice of subsidies rather than any other policy instrument appears to be relatively straightforward. No other instrument was acceptable, particularly the use of a public corporation. While the reasons for this are rather obvious in the case of the United States, it is no less so for the Canadian and Ontario situation in the 1960s and 70s. Canada already was employing a Crown corporation and was permitting it to withdraw from non-profitable routes, particularly as government policy was beginning to allow for the introduction of air carrier competition. Such competition would inevitably constrain Air Canada's ability to engage in internal cross-subsidization and it was inconceivable that a subsidiary or new government entity be established to serve small or remote communities. In the case of Ontario, there is no evidence that the provincial government ever contemplated the creation of a publicly-owned carrier, a fact which is somewhat ironic given the transformation in its subsidy program in the last five years into exactly that.

Explaining the choice of subsidies over alternative instruments does not account, however, for the decision to introduce a subsidy program. With respect to this issue, a distinction should be made between the U.S. and Canadian programs and the Ontario subsidy system. The two former programs were largely politically motivated, whereas the latter was clearly more service-driven although obviously there were political considerations. A subsidy program was a sine qua non for enactment of the U.S. airline deregulation legislation. The administration was reluctant to embark on such a program

given the decades-long problems of the original, apparently uncontrollable program. If forced to do so, as it was, it would only accept a program that was service - and not carrier - specific, unlike the original, and at as minimal a cost as possible. This accounts for the specific criteria limiting both the nature of the aircraft and communities eligible for subsidization.

The Canadian program would appear to be the result of an equally reluctant political decision. The Government of Canada was reluctantly permitting enhanced competition with the publicly owned carrier and wanted to limit that competition as much as possible so that the performance of Air Canada would not be diminished, i.e. so that it would not make demands on the public purse. The subsidy program was introduced to compensate the regional carriers for the territorial constraints being placed on their operations with the objective of minimizing objections from those carriers and their provincial advocates. In my judgment this rationale explains why no serious effort was made to make the criteria cited above operational. The program was not strictly intended to be a service as opposed to a carrier subsidy. Consequently, as with the original U.S. program, allocation of subsidies would be based more on the "health" of the individual recipients and any other claim they could make rather than the service needs of individual communities.

The Ontario program was designed for an explicit two-fold purpose. The first was the introduction of a necessary level of intra-regional service to compensate for the absolute lack of any alternative or the time and expense of existing alternatives where available. The other purpose was to provide feeder service into the larger communities so that access to trunk service could be introduced or improved. The Ontario Government's original reluctance to subsidize a specific carrier clearly carried over to the development of the subsidy program. While it was unavoidable that political pressure would play some role in the selection of subsidized communities, the choice of aircraft and the gradual approach adopted to the extension of the service argue that the province was concerned about acceptable minimal levels of service demand. This concern was related to keeping the size of the program under control. In this regard it is worth noting that the program

annually announces the subsidy per passenger but does not measure the cost of the subsidy per route as the American program does.

Turning to the issue of the success of the individual programs and the factors accounting for success, the initial objectives must be kept in mind. In the case of the Canadian federal program "success" was at best problematic. The unfocussed nature of the program could have made it a serious problem, similar to the original American program, if external factors had not intruded to remove the rationale for the program. In the American case, in light of the twin objectives of cost control and continued service to communities without alternatives, the program should be judged a success. In fact within the U.S. Department of Transportation, the view would appear to be that the program is unnecessary but is not such a cost burden to justify the political battles, probably unwinnable, to terminate it. The basic elements conducive to the success of the U.S. program appear to be very rigid definitions of minimal levels of service that will be subsidized, realistically defined distances to "hub" communities for eligibility and public tendering on a competitive basis. The combination of these three factors has controlled the cost of the program and particularly has significantly reduced the cost compared to the pre-1978 subsidy program as well as avoiding carrier-specific subsidies. A primary goal of the American program has been to keep subsidies to a minimum and it appears to have succeeded in meeting this objective.

An assessment of the norOntair program is more complex. In the twenty years of operation the program has expanded significantly both in terms of communities serviced and passengers carried. It has also faced some difficult years when passenger levels have seriously declined, with corresponding growth in the proportion of subsidy to revenue. The Ontario Government's proposal in the mid-80s to sell off its assets to a private carrier suggests a concern over excessive or uncontrollable costs despite the attempt to impose strict criteria for extending service to a specific community. Similarly, the initial decision to take over a bankrupt carrier's norOntair operations followed by the decision to transform norOntair from a subsidized system into an operating unit of a provincial Crown corporation, albeit still with an operating subsidy, suggest that the program has not been all that successful, notwithstanding the original controls.

On the other hand, the growth in passenger service, the growth in intra-regional service, the continued commitment not to compete with other carriers and the gradual reduction in the subsidy per passenger are facts that argue for a positive assessment of the program. There is no evidence that the existence of the program is a cause for controversy; nor is there any apparent pressure for its elimination. The transfer of norOntair to the Ontario Northland Transportation Commission (ONTC) as an operating unit suggests perhaps that norOntair should now be regarded as a government operated, rather than as a subsidized, air service, although the ONTC must negotiate on a regular basis with the Government of Ontario over the amounts of subsidy it will receive.

The lessons to be drawn from the three case studies would appear to be obvious. If the objective is to provide a minimal level of acceptable service to small or remote communities at a controllable cost to the public, the following conditions should be imposed:

1. Subsidization should be based primarily on a competitive tendering process and the objective should be to subsidize service to passengers and not a specific carrier.
2. The subsidy plan should clearly define the minimal levels of service that need to be met in terms of passenger loads, number of flights and type of aircraft. The presumption of the U.S. program that anything above those minimal levels is sufficient evidence that a subsidy is not needed should be a cornerstone of the program.
3. Subsidy systems, as the American and norOntair programs demonstrate, are not easily terminated. Nevertheless, in order to subject the program to continuing scrutiny to ensure the objectives are being met and not supplanted, the program could be "sunsetting" subject to renewal or at a minimum to a timely periodic review. Anything less could lead to a self-perpetuating program.

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